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The Euro: Who wins? Who loses?

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Abstract:

The good news is that the European Union will soon have a single currency. The bads news is that the fight over monetary policy has just started and it is going to get nasty.

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Europe's economic and monetary union (EMU) is the result of 25 years of political battles among and within the continent's nations. Several times-most notably in the early 1980s and again in the early 1990s-the European Union (EU) nearly tore itself apart as it attempted to stabilize the fluctuations of the European countries' different currencies and move toward a single currency. In the end, supporters of a common currency won.

In January 1999, 11 European countries will adopt the euro. For three years, they will use the common currency instead of their existing national currencies for large-scale trade and payments. Then, in 2002, euro coins and notes will take the place of national currencies in everyday circulation-that is, in the wallets and minds of Europeans. With the end of the battle over a common currency, Europeans have a more momentous, and more contentious, task before them: to agree on a common monetary policy for Europe's disparate countries, regions, and groups and to manage the political clashes that this process of agreement will unleash. The struggle for control of Europe's most important tool for economic policy pits powerful conflicting interests against one another. And these skirmishes are likely to have

substantial effects on the European economy, and on the course of European integration in general.

MONETARY UNION'S POLITICAL ROOTS

Economists agree almost unanimously that the purely economic benefits of establishing a monetary union do not outweigh the costs (see box on page 30). This conclusion may be open to question, but even skeptics agree that political factors have been paramount in the drive for monetary union.

But politics encompasses many different things. Three principal factors made the euro attractive and feasible:

The quest for anti-inflationary credibility. Under a single currency, countries with relatively high inflation, such as Italy and Finland, could tie their currencies to that of a low-inflation country, such as Germany, to help reinforce perceptions about their commitment to bringing inflation down.

Broader links to European integration. Once the quest for a zone of monetary stability in Europe was under way, countries that were not participating worried that they would be excluded from other initiatives and, thus, be relegated to second-class citizenship within the EU.

Support from powerful business interests. The prospect of exchange-rate stability and a single currency won the solid backing of most large corporations and banks in Europe. Big businesses believed that removing the uncertainties of currency fluctuations would help them realize the full promise of a single European market, and give them a larger effective home base from which to confront outside competitors. These three forces were strong enough to carry 11 EU members through to EMU. And they will almost certainly be strong enough to carry the Euro-11-and maybe even a few more countries-through to full implementation of the single currency in 2002.

Of course, the transition to full currency union between now and 2002 might run into difficulties. Why might one of the Euro-11 drop out? The countries involved vary greatly in their economic structures and problems, a principal reason why many economists doubt the wisdom of undertaking the EMU enterprise in the first place. A monetary policy that might be right for France and Germany could prove very costly for Spain or Portugal. Spain's current unemployment of 19 percent-and youth unemployment of around 40 percent-might become politically intolerable, and national attempts to reduce it may seem inconsistent with the tight monetary policy of the new European Central Bank (ECB). A strong euro that increases the price of Europe's exports and cheapens the cost of its imports might drive Portuguese manufacturers to the wall, and the ECB might refuse to weaken the common currency to make Portuguese knitwear more competitive.

Overblown expectations about the economic consequences of EMU may aggravate these transitional tensions. After years of slow growth, high unemployment, and worsening social problems, many Europeans hope that EMU will point the way toward greater prosperity. But the new central bank is likely to argue that it cannot solve decade-long structural problems, and that attempts to use looser monetary policy to stimulate the economy will only lead to a new round of inflation. Should raised expectations clash with restrictive ECB policy, some national publics might rethink their support for the euro.

But it would take severe economic and political difficulties to shake any of the current EMU members loose from the euro. Their concerns about being left out of a central EU institution, losing the continued support from big business, and walking away from the years of hard work that got them into Europe's monetary club in the first place will probably pull all of the euro zone through to 2002.

IDENTIFYING WINNERS AND LOSERS



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Lower Prices, Fewer Jobs

Up to this point, the French, Germans, Italians, and others have debated whether they should join EMU. Domestic supporters and opponents have clashed over a particular country's adherence to monetary union, as often happens in national disputes over trade or social policy.

From now on, however, the question facing Europeans is not national but continental in nature: What Europe-wide policy will their new joint central bank follow? The answer will reflect the push and pull among Europe's various interest groups, the pressures of public opinion in different countries, and complex calculations about costs and benefits.

Two dimensions of debate will come to the fore. The first is internal, the ECB'S making of a "domestic" monetary policy. Although the euro zone is not one country, it will be for monetary purposes, and it will face the usual problems confronted by national monetary policymakers. Here, the tradeoff will lie between sustaining the region's current low inflation and stimulating growth and employment. The difficulties inherent in this tradeoff are compounded by the extraordinary diversity of European economic conditions and interests.

Some of the EU's most influential groups and countries place extremely high value on very low inflation. For years, all potential EMU members have had to follow the lead of the German central bank-the Bundesbank, one of the most tough-minded guardians of financial probity in the world-even at the expense of other political and economic concerns. Lowering the ECB'S inflation-fighting guard would incur the wrath of the continent's central bankers, who are backed by most of its banks and big businesses.

Then again, there is strong public sentiment throughout Europe behind lowering interest rates to deal with slow growth and high unemployment, even if doing so means incurring somewhat higher inflation. The region has lived with double-digit joblessness for a decade, with the unemployment rate reaching well above 20 percent in some countries. The roots of Europe's high and persistent unemployment are buried deep in its social and political structure-there is no easy solution. Although monetary policy cannot do much to fix what is broken in Europe's labor markets, the Bundesbank's nearly single-minded pursuit of zero inflation has probably slowed growth and raised unemployment across the continent.

In fact, one reason why EMU has garnered strong support in Europe is that it will transfer control of European monetary policy from the hardmoney Bundesbank to the presumably less-extreme ECB. Labor unions around Europe will register their dissatisfaction if the ECB shows too little concern for the growth and employment effects of policies. Small businesses and mortgage holders are also likely to want low interest rates.

The second fault line for Europeans is external: namely, ECB policy toward the value of the euro in

foreign-exchange markets. In this case, they must choose between having a euro that rivals the dollar as an international currency and a weaker euro that makes European goods more competitive with those of other continents.

Europe's financial press has been filled with hopeful predictions that the euro will challenge the dollar for use in official currency reserves and in international trade and investment. This strengthened status, of course, requires a currency that inspires international confidence-that is, a robust euro, one not subject to sudden and unexpected fluctuations.

A strong common currency is also attractive to European financial markets. After all, the powerful position of U.S. banks and corporations is related to the dominant global position of the dollar. The widespread use of the dollar in international payments and investment almost certainly increases demand for the services of U.S. banks, while the denomination of most world trade in dollars probably gives American exporters a competitive edge. Many European businesses hope that international faith in the euro will translate into similar international success for Europe's financiers and investors by making it easier and more attractive for foreigners to use European banks and buy European goods and services.



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Europe's Monetary Politics: Who Benefits?

But a strong euro will make foreign products cheap relative to European ones. For this reason, there are powerful pressures to keep the euro from appreciating against the dollar and other currencies. Thus, Europe's exporters and import competitors are a force against encouraging or allowing the euro to strengthen, a trend that could be especially troublesome as more and more goods from Asia and other low-wage regions push into European and third country markets.

Of course, the two dimensions of monetary politics are tightly linked. More restrictive policies mean higher interest rates and a stronger euro; more stimulative policies mean lower interest rates and a weaker euro. The interrelationship of internal and external policies-and their connections to trade, fiscal, and other policies-only make tough choices even harder.

Although monetary policy is complex and the outcomes associated with it cannot be forecast perfectly, we can identify a general lineup of winners and losers from the different monetary policy stances. In principle, of course, nobody likes inflation or a weak currency; the question then is how much importance should be placed on fighting inflation or strengthening the euro, given that both imply raising interest rates and the relative prices of European goods on world markets.

A strong euro and tight money suggest a priority on international confidence in the currency and low inflation. The two tend to go hand-in-hand: High interest rates to keep inflation down will make the currency more attractive and raise its price (exchange rate). Europe's big international investors, banks, and corporations are focused on the strength and reliability of the currency, and the stability of monetary conditions "at home" in the euro zone. Europeans with savings will certainly benefit if interest rates are high and inflation is kept in check, but a strong anti-inflationary stance and an emphasis on the

currency's international standing typically come at the expense of employment and the competitive position of those producing for export markets or competing with imports.

A weak currency and loose money are associated with aggressively using the exchange rate to help Europeans compete with foreign producers and using interest rates to stimulate a sluggish economy. Low interest rates too are important to borrowers as well, especially to those with home mortgages to pay. The labor movement is also a good example of a powerful constituency that supports the idea of accepting a little more inflation in the interest of stimulating the economy.

Of course, some groups will find themselves torn. European exporters want a currency that is both reliable and weak; they may have to choose one or the other. Those manufacturers that produce goods whose price is not a major competitive factor-luxury cars or high-quality electronics, for example-probably find currency stability more important than a depreciated euro. But Europeans who make products that underpricing can drive out of the market-clothing, shoes, steel-are much more about the currency's value.

CONFLICTS TO COME

The ECB thus faces pressures from the outset that cannot all be satisfied. It is not hard to design a popular monetary policy when the economy is growing and incomes are rising, but in times of trouble, whatever the ECB does will be unpopular with some of its constituents.

The three most obvious potential scenarios for conflict among Europe's competing interests are the following:

Recession

The European economy-or portions of it-tumbles. Recession-ravaged countries, regions, and groups-weary of stagnation-demand that the ECB help them. Monetary hardliners-wary of inflation-insist that the recession is a local problem or a necessary corrective and that the inflationary alternative is far worse. If the ECB responds to those in trouble with expansion, foreign-exchange traders could desert the euro, causing a debilitating currency crisis. If the ECB holds firm, its resolve could cause a political backlash aimed at reining in the central bank or otherwise altering European policy.

Localized Financial Crisis

One of Europe's notoriously weak financial systems, say that of Spain, is threatened by a wave of bank failures. The national authorities are unable or unwilling to foot the enormous bill needed to stave off bank runs and incipient panic. They turn to the ECB, demanding a loosening of monetary policy to help their banks. Perhaps they even insist that the ECB and its member central banks provide short-term loans to the troubled Spanish banking system.

The ECB could bail out its bankrupt member. This course would be unpopular in countries unaffected by the crisis, for the bailout might mean raising inflation elsewhere and sending other people's money to Spain. And the bailout might itself encourage a run on other weak banks, now that the ECB has set the precedent of making bad loans good. Or the ECB could ignore the local crisis and let Spain pay the consequences. This alternative risks Spanish resentment of the central bank and its partners. And it also risks the transmission of the crisis to the rest of the euro zone, for financial panic in one region of a currency union can rarely be segregated from the rest.

Crisis Abroad

The Japanese economy continues to slump, the Asian crisis worsens, and the American bull market comes to an abrupt end. Collapse on Wall Street causes a wave of bank failures in North America and a new debt crisis in Latin America. Asian, Latin American, and North American producers raise barriers to foreign goods and ship their unsold products to Europe at fire-sale prices.

Europe's leading banks and corporations see in this crisis an ideal opportunity for them to supplant their Japanese and American rivals and for the euro to take its place as the most reliable currency in the world. They, along with the continent's central bankers, call for the ECB to redouble its commitment to monetary rectitude. But many European manufacturers and farmers are being devastated by the flood of cheap imports and lost access to foreign markets. They demand that the euro be allowed to decline in value to keep pace with the dollar and yen. Meanwhile, Europe's key financial and commercial centers want a strong euro, while low-wage manufacturing and farming regions need a weak currency. The ensuing battle pits north against south, city against countryside.

None of these scenarios is novel: For most large countries, including the United States, these constraints have been central to macroeconomic policy for years. But they have not been faced by the EU as an entity, for it has not had a currency or monetary policy-until now. With the inauguration of EMU and the euro, the EU will have to deal with cross-cutting social and political demands that it cannot meet without calling one or another of its central commitments-free trade, price stability, economic growth, employment creation-into question.

THE MYTH OF INDEPENDENCE

In theory, this European clash of interests should not matter, for the ECB is supposedly above politics. Its constitution is designed to make it mimic the hard-line Bundesbank. And yet the new central bank will have to be sensitive to the desires and demands of Europe's businesses, labor unions, politicians, and others. If it strays too far from the preponderance of opinion and interests in the EU, it will be brought to heel. The manner is as yet undetermined-perhaps via national government threats that are channeled to or through "their" bank board members, or the European Parliament's incipient oversight, or backchannel influence from the European Commission-but the ECB will definitely be unable to ignore the opinions of powerful Europeans.

Any lingering doubts about the ultimate arbiters of European policy were put to rest at the very birth of the ECB. In April of this year, the French government insisted that the bank's first president, Willem (Wim) Duisenberg, serve only half his term and then resign in favor of a Frenchman, Jean-Claude Trichet. The French were able to override the desires of all other EMU members and of the overwhelming majority of central bankers in a carefully structured political deal.

This episode was meaningless in a practical sense, since Duisenberg and Trichet are virtually indistinguishable as central bankers. The true lesson-and, probably, the true reason for French insistence on a political deal-was symbolic. It demonstrated conclusively that the ECB serves at the sufferance of member states and their political leaders.

This circumstance is nothing new for central banks: An apolitical central bank is an oxymoron. But the ECB faces the difficult task of finding balance among much more disparate regions and interests than is the case in most countries. As a novel creature, it is desperate to establish its credibility with financial markets. Meanwhile, the ECB will be a brand-new player on the international economic scene, drawn immediately into the maelstrom of international financial diplomacy and emerging-market bailouts. And

the institutional uncertainties of the new monetary union will make the political obstacles that the ECB has to negotiate more treacherous.

The formal structure and responsibilities of the ECB are clear. Like most central banks, it has a governing board that meets periodically to decide how to react to economic conditions. It can use a variety of instruments to intervene in financial markets to raise or lower interest rates, and to raise or lower the value of the euro. Central bankers are busy working out the technical details of how the ECB will in fact operate, but essential political considerations remain unclear.

National central banks have the backing of national political authorities. Typically, they are semiautonomous agents of the government, who are required to report periodically. However, there is no "government" of EMU, no analogue to the national governments to which national central banks are responsible. In other words, there is a void at the center of Europe's new monetary institution.

In addition to formal lines of responsibility, successful central banks rely on informal relations with politicians and financial markets that usually take years or decades to develop. If monetary policy appears too much in thrall to private banks, it risks a reaction from popular political representatives. But if monetary policy seems too politically motivated, it loses the confidence of financial markets.

Since the 1930s, the American central-banking compromise has meant a Federal Reserve System dominated by the financial sector and tempered by congressional oversight. Although uncomfortable for all parties most of the time, the balance has dampened strife over monetary policy

The ECB, however, lacks established lines of communication with both financial markets and the European public. It will take time for a system of accountability to financial markets and politicians to develop. In the United States, control of the Fed was hotly disputed and uncertain for more than 20 years after its 1913 founding. A stable compromise was arrived at only in the mid-1930s.

Contested monetary institutions can have two disastrous effects. The first is paralysis in a crisis, as nobody has the authority to act forcefully. The Great Depression of the 1930s was probably exacerbated by Fed dithering—the result of political dissension among the New York Fed, regional reserve banks, the Fed Board in Washington, Congress, and others.

A second effect of central-banking institutions with unclear lines of accountability, authority, and communication is excessive influence by those with informal ties to the central bank, generally private financiers. And the perception that monetary policy has slipped away from public control into the hands of the financial markets can cause a powerful political backlash.

For the foreseeable future, the ECB is likely to lack the political ability to act decisively. And it will probably be called on to do so—either because of local financial difficulties or fundamental disagreements over European monetary policy. Moreover, incomplete mechanisms for ECB political accountability will aggravate the underlying difficulties of the new central bank's job.

WHAT TO EXPECT None of this is to say that EMU is a bad idea or that it is doomed to failure. In fact, it is likely to have many positive effects and has political support that is broad and deep enough to ensure that it will probably endure any but the gravest of difficulties.

The political realities of today's EU will define the future of the euro. One of these political realities is that almost any possible monetary stance will excite opposition from powerful Europeans. There are important constituencies that favor tight and loose money and a strong and a weak euro. This dynamic is

no different from what happens in any country, from Australia to Zambia. The novelty of EMU is that the pulling and hauling among different sectors is multiplied many times by the great diversity of Europe's economies and by the even greater diversity of European political and social organizations and institutions.

The ECB will be unable to rely on broad consensus over monetary policy. Especially in times of stagnation or crisis, it will be the focus of intense political pressure from business, labor, governments, and regions with divergent interests.

Another political reality is that the ECB will have to take these political pressures into account. The new central bank will need to find a way to address the legitimate concerns of its European constituents, varied as they might be. The ECB's response to the winners and losers of Europe's monetary experiment will determine the future course of the euro and of European integration.

WANT TO KNOW MORE?

EMU is a the product of recent economic and political developments. Daniel Gros and Niels Thygesen, two strong supporters of EMU, present this historical context in their book, *European Monetary Integration*, (London: Longman, 1998). Readers should also consult *Forging an Integrated Europe* (Ann Arbor: University of Michigan Press, 1998), edited by Barry Eichengreen and Jeffry Frieden.

Peter Kenen, one of the best-informed academic observers of EMU, offers a summary of the issues in his book *Economic and Monetary Union in Europe: Moving Beyond Maastricht* (Cambridge: Cambridge University Press, 1995). Charles Wyplosz wrote his well-respected article "EMU: Why and How It Might Happen" (*Journal of Economic Perspectives*, Fall 1997) when many observers were just beginning to take the prospect of EMU seriously. For a more recent and extended analysis, read the articles collected in *The New Political Economy of EMU* (New York: Rowman and Littlefield, forthcoming), edited by Frieden, Gros, and Erik Jones. In his paper *Europe's Gamble* (Washington: Brookings Institution Press, 1997), leading macroeconomist Maurice Obstfeld discusses the potential for economic and political problems in a functioning EMU.

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